"We are making significant revenue here."

Peter Forsyth, Kaiser Aluminum's Vice President for Northwest Regional Affairs, as quoted in the Seattle Post-Intelligencer regarding Kaiser's windfall from remarketing low-cost BPA power (December 11, 2000)

A report on the remarketing of BPA power by DSIs and the implications for Northwest ratepayers of another "special deal" for DSIs

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Summary of Findings

An unprecedented combination of near drought conditions, an over-commitment of resources by the Bonneville Power Administration (BPA), and dysfunctional Western wholesale electricity markets threaten to lead to steep rate increases for Northwest consumers beginning October 1, 2001.

Besides the obvious strain on family budgets, rate increases of 50-250 percent, around half of which will be passed through to residential ratepayers, will serve to exacerbate our region's, and indeed the nation's, economic problems.

One way BPA has identified to help keep rate increases as low as possible is to shed the load (1,500 megawatts) contracted to the region's direct service industries (DSIs). The stakes are high. According to one estimate, for every 100 megawatts of power BPA has to purchase to serve DSI load, rates for other Northwest consumers will rise around 10 percent. Even if no other steps are taken to deal with the energy crisis, removing the DSI load would cut the amount of power BPA would be forced to buy on the volatile wholesale market virtually in half. The DSIs have responded by proposing a variety of special deals that would force other ratepayers in the Northwest to subsidize their operations. Negotiations between BPA and the DSIs are ongoing.

When considering whether to grant a special deal to the DSIs, which I strongly oppose, it is important to understand what they've gained under the previous special deal they received in 1995-96.

In order to keep the DSIs on the BPA system in the mid-1990s, when BPA's prices were above market rates, BPA agreed to contracts with some of the DSIs that allowed them to resell on the wholesale market any excess, low-cost power they received from BPA. With the skyrocketing wholesale prices on the West Coast, this right to remarket has led to huge windfalls for those DSIs. Some have gone so far as to intentionally shutter their operations in order to resell a maximum amount of power and earn huge profits. As a Kaiser spokesman said, "We are making significant revenue here." That is an understatement.

Here are a few highlights:

- The DSIs are expected to make $1.4 billion remarketing BPA power in fiscal year 2001.

- When combined with payments made by BPA to the DSIs for voluntary load curtailment, the DSIs earned approximately $1.7 billion.

- Even accounting for revenue a few of the DSIs are sharing with BPA, as well as money the DSIs still owe BPA for power, the DSIs still come out ahead with net revenue of $1.5 billion and the potential to make $153 million more (depending on wholesale market prices) until remarketing rights end in September.

- The largest remarketing windfall recipients are Kaiser ($485 million), Goldendale ($480 million) and Columbia Falls ($384 million).

Come October, rate increases are guaranteed to occur. But, if BPA is going to mitigate the damage, it must have cooperation from the DSIs. A reasonable solution is for BPA to purchase power back from the DSIs at a minimal rate set well below the price of power in the wholesale market. Further, the payments should be conditioned on the DSIs using the money to cover salaries and benefits for workers, investment in alternative sources of energy that would keep the DSIs off the BPA system, and, for facilities that don't intend to remain operational, retraining for workers.

Context for the current crisis

The litany of challenges confronting the Northwest have been well-documented. As of March, Columbia basin snowpack was only 53 percent of normal, near the historic low of 1977. Similarly, water run-off is currently the second lowest in the 72 years for which records are available. Streamflows have fallen from the 10th worst on record to 3rd worst in just four months. Every time I receive a briefing from BPA, these numbers get worse. At this point, even the wettest spring on record would probably not provide much relief.

According to a recent report by the Northwest Power Planning Council, if water conditions remain near a historic low, the Northwest could face an 8,000 megawatt deficit this summer.

Just as ominous, as Steve Wright, Acting Administrator of BPA, recently noted in a speech, "We are becoming increasingly concerned that this may not just be a problem for this summer. Canadian reservoirs, which store half the system's water, are extremely low this year, which means we could start next year with less than a full tank."

Mother Nature is a key culprit in our energy woes, but clearly not the only one.

Another is the volatile wholesale energy market in the Western United States. Wholesale prices are five to six times what they were just one year ago. Historically, Northwest electricity prices have been about $25 a megawatt hour. Prices today in the West are hovering around $200-300 per megawatt hour or more at a normally cheap time of year. In January of this year, prices actually spiked to an unheard of $1,000 a megawatt hour. BPA alone spent $50 million in just four days on power purchases to keep the lights on in the Northwest.

A recent report in the *San Jose Mercury News* indicates prices won't get any better this summer. Stanford University economist Frank Wolak, who is also head of the Market Surveillance Committee for the state's main power grid, predicts "the sky's the limit this summer." The futures markets are already trading August contracts for electricity in the West for as much as $750 per megawatt hour. (Futures contracts allow investors to reserve the right to buy a commodity at a set price on a later date).

After power contract negotiations ended last fall, BPA found it had committed to providing customers with 11,000 megawatts of power. But, BPA's current generating resources can provide only around 8,000 megawatts of power, creating a 3,000 megawatt deficit going into the October rate period. If BPA can't find ways to reduce load, it will have to buy power on the wholesale market to cover the difference. That could force untenable rate increases or threaten BPA with bankruptcy.

Therefore, BPA is taking steps to reduce the load it has contracted to serve and limit exposure to the wholesale market. BPA has entered into a few voluntary curtailment agreements with DSIs, encouraged conservation, shipped power to California on a 2-for-1 exchange, and declared power emergencies in order to run the hydro system for maximum output. Unfortunately, these steps will not be enough.

DSIs gain remarketing rights

1996 Remarketing Rights:

In the mid 1990s, BPA's rates were above market rates. It's hard to believe now, but market rates initially went down after wholesale energy deregulation. The DSIs threatened to leave the BPA system and get all of their power from the wholesale market. Concerned about the finanicial threat posed if there wasn't enough demand for BPA power, then-Administrator of BPA, Randall Hardy, offered a special deal to the DSIs.

The DSIs signed "take-or-pay" contracts. This required them to pay for a fixed amount of power regardless of whether or not the power is actually scheduled and delivered. The DSIs expressed concern about their obligation to pay in the event of a downturn in their industry that forced curtailment or closure of operations.

In response, BPA offered the DSIs two options to mitigate that risk: curtailment or remarketing. Under the curtailment option, the DSI pays $4.95 per megawatt hour for curtailed load (the amount and duration of which is determined by the DSI in advance). Bonneville then takes the risk of remarketing the power.

Under the remarketing option, BPA agreed to give the DSIs the right to resell on the wholesale market any of its excess take-or-pay power. Either BPA or the DSI may find a purchaser to whom BPA then resells the power on behalf of the DSI.

I opposed the signing of the contracts that granted DSIs remarketing rights in 1996. If wholesale power was going to be so inexpensive that the DSIs were willing to abandon BPA, then why would the DSIs want to sell excess power into that market? The DSIs must have felt they knew something about the future direction of wholesale energy prices that BPA didn't.

I was able to convince Charlie Curtis, an Undersecretary at the Department of Energy and the individual who had to sign-off on the BPA contracts, to oppose the contracts with the remarketing provisions as well as other giveaways to the DSIs. Near the final hours for approving the contracts, however, I received a call telling me Mr. Curtis had been overruled by then-Secretary of Energy Hazel O'Leary, who demanded they be signed.

Recent addendums to remarketing rights:

As wholesale prices on the West Coast soared beginning in the Summer of 2000, it suddenly became an extremely attractive option for the DSIs to exercise their right to remarket power. In order to discourage the DSIs from simply shutting down if it became more profitable to resell power than produce aluminum or some other product, BPA negotiated conditions on the right to remarket. BPA and the DSIs agreed revenues generated by the DSIs through remarketing could only be spent on:

- Purchasing power in the October 1, 2000 through September 30, 2006 period to help maintain smelter operations in the Pacific Northwest;
- Mitigating the impact on employees affected by reduced smelter operations;
- Offsetting cancellation penalties and other costs of reducing obligations for alumina and other materials; or
- Covering fixed operating costs the company demonstrates cannot be reduced as operating levels are reduced.

In addition, some of the contracts included the right for DSIs to use remarketing revenues to improve the energy efficiency of their operations or to build their own generation.

Unfortunately, these restrictions were not enough to keep Kaiser Aluminum from shutting down plants in order to sell their low-cost BPA power for huge profits in the Western wholesale market.

This right to remarket low-cost BPA power, which will not be renewed when the current contracts expire at the end of September, has been a boon to some DSIs and made their negotiators look like geniuses. Those DSIs have taken power they pay around $25 a megawatt hour for and sold it on the wholesale market for prices ranging from $200-$1,000 a megawatt hour.

Unfortunately, it has also exposed BPA to a new round of attacks from its enemies in the California congressional delegation and Members of Congress from the Northeast and Midwest, many of whom have introduced legislation to end regional preference for BPA power, privatize BPA, or force BPA to sell power at market rates rather than at cost. Any of these steps would be devastating to Northwest ratepayers and our economy.

Company by company analysis of remarketing benefits

Not all DSIs elected to take remarketing rights in their contracts. And, not all DSIs who have remarketing rights have exercised them equally. For example, according to press accounts, Goldendale has used its remarketing windfall to provide compensation to idled workers and to invest in its own generation in order continue operations and stay off the BPA system. Goldendale has also agreed to share some of the revenue it has made with BPA.

By contrast, Kaiser is essentially taking the money and running. Kaiser shut down operations and offered workers few benefits. According to some accounts, Kaiser has no intention of ever reopening its plants since they have begun moving equipment from their Northwest operations to other parts of the country. Kaiser has also adamantly refused to share any of its windfall with BPA.

Unfortunately, BPA has not exercised its rights that were written into many of the remarketing contract addendums to "conduct limited audits...for the sole purpose of confirming that obligations were actually made or incurred for Qualified Expenditures." As mentioned previously, Qualified Expenditures included payments to workers, among others. Because BPA has not yet conducted audits, other than the occasional press story, it is not entirely clear how the DSIs have spent the money they've made. But, make no mistake, the money has been significant.

<u>Kaiser:</u>

Remarketing revenue		$485 million
Amount still owed to BPA for power	-	$59 million
Remarketing revenue shared with BPA		ZERO
Net revenue		**$426 million**
Potential for additional revenue at forecasted market rate of $350/Mwhr		$45 million

Potential net revenue		$471 million

Columbia Falls:

Remarketing revenue		$384 million
Amount still owed to BPA for power	-	$32 million
Remarketing revenue shared with BPA	-	$60 million
Net revenue		**$292 million**
Potential for additional revenue at forecasted market rate of $350/Mwhr		$92 million
Potential net revenue		$384 million

Goldendale:

Remarketing revenue		$480 million
Amount still owed to BPA for power	-	$51 million
Remarketing revenue shared with BPA	-	$85 million
Net revenue		**$344 million**

Oremet:

Remarketing revenue		$2.7 million
Amount still owed to BPA for power	-	$0.2 million
Remarketing revenue shared with BPA		ZERO
Net revenue		**$2.5 million**

The DSIs that chose the curtailment option also made significant revenues. These beneficiaries include:

Longview	$173 million
Alcoa	$210 million
Atofina	$4 million
Vanalco	$900,000

DSI tiered rate proposal

BPA is facing a 3,000 megawatt deficit in the next rate period. The DSIs have contracts for 1,500 megawatts of power, or enough to cut BPA's deficit in half. Clearly, the DSIs will have to play a large role in helping to limit BPA's exposure to volatile wholesale prices and minimize rate increases.

The DSI proposal

In response to the crisis, the DSIs have been promoting their proposal for a tiered rate. Under the DSI plan, all BPA customers would get approximately 75 percent of their load served at a cost-based rate. The other 25 percent would be served at the market rate, theoretically sending price signals to customers to conserve. According to the DSIs, this proposal is fair because it allows each customer to conserve or not to conserve power in order to avoid higher rates. They also claim this plan could allow the DSIs to keep operating, albeit at reduced output.

While flexibility, consumer choice, and price signals may sound good in theory, in practice, the DSI plan will mean much higher rates for everyone but the DSIs.

Problems with the DSI Proposal

Not all customers have equal ability to conserve

The DSIs reject the notion that they get a "special deal" under the tiered rate proposal since everyone would receive 75 percent of their power at-cost. However, it is clear other BPA customers, such as public power (which serves residences, businesses, schools, hospitals etc.), can not just automatically cut 25 percent of their load. By contrast, it is relatively easy for the DSIs to scale back production by 25 percent in order to ensure all of their power is delivered within the first tier of at-cost power. This shifts the burden of market rate power onto other customers. That clearly qualifies as a special deal for the DSIs.

It is also important to keep in mind when considering whether to grant the DSIs a special deal that most DSIs would not be able to continue operating if BPA merely increased rates in order to cover its purchases on the wholesale market. In other words, if the DSIs were forced to pay the same price BPA charges other customer utilities, it is unlikely many will continue operating.

Electricity accounts for around one-third of the cost of running an aluminum smelter. The industry estimates that power prices over $30 a megawatt hour make it uneconomical to operate. Therefore, if BPA is forced to cover its 3,000 megawatt deficit through purchases on the wholesale market, even with a best case scenario of $40-50 per megawatt hour, it would not be profitable for the DSIs to continue production.

According to an estimate by the Public Power Council, at current wholesale prices (around $315 a megawatt hour), if BPA is not able to reduce load at all, prices in fiscal year 2002 will increase by 408 percent. By contrast, with a 1,500 megawatt load reduction, which could be achieved by removing the DSIs from the BPA grid, rate increases would drop to 202 percent, which is still a substantial hit. Even if prices dropped to $140 a megawatt hour, with no load reduction, rate increases would average 172 percent. Without the DSI load, at $140 a megawatt hour, the rate increase drops to 92 percent.

Not all customers have equal standing for BPA power

When considering how to allocate the benefits of Bonneville power, it is important to understand that not all BPA customers come to the table with equal standing. The Bonneville Project Act of 1937 puts public power first in line for the benefits from our hydro system. Section 832c(a) of the 1937 Act reads:

> In order to insure that the facilities for the generation of electric energy as the Bonneville Project shall be operated for the benefit of the general public, and particularly of domestic and rural consumers, the administrator shall at all times, in disposing of electric energy generated at said project, give preference and priority to public bodies and cooperatives.

In advancing their tiered rate proposal, the DSIs are attempting to jump ahead in line for the benefits from BPA power in contravention of the law.

Price signals are already sending conservation messages

It is not necessary to use a tiered rate to send a high, sustained price signal to generate conservation or construction of additional capacity. The rate increases already imposed by various utilities, the general feeling of community in our region, and the prospects of a large BPA rate increase (even without a special deal for the DSIs) have led to positive steps toward conservation and construction.

Consumers in the Northwest have already been conserving at a rate of 4-10 percent. In addition, more than 3,000 megawatts of generation is now fully permitted in the Northwest with 20,000 more megawatts in the regulatory pipeline. About 800 megawatts of capacity is expected to be online during the first half of 2001, with an additional 700 megawatts available by this winter.

A stark choice

If California had not botched its energy deregulation plan and distorted the entire Western wholesale market, and if BPA was not suffering a near record drought, ideally we would be entering the next rate period with only a modest rate increase and few jobs lost. Even with those unprecedented factors, if the Federal Energy Regulatory

Commission (FERC) would fulfill its statutory obligation to enforce "just and reasonable" wholesale electricity rates, the damage to the Northwest would be greatly reduced. Unfortunately, given current circumstances and the indifference of FERC, we're confronted with a stark choice - - large rate increases for all customers, with significant job loss across-the-board or curtailment of the DSI load, compensation for DSI workers, and lower (but still significant) rate increases for other customers. According to testimony before the Northwest Energy Caucus by Mark Gendron, General Manager of Idaho Falls Power, for every 100 megawatts of power PBA has to purchase to serve DSI load, rates for other Northwest consumers will rise around 10 percent.

Removal of DSI load from the BPA system for at least two years could cause the temporary loss of 7,000 jobs for working families. However, the alternative is tremendous disruption of the entire Northwest economy, layoffs of tens of thousands of individuals from manufacturing firms, small businesses, and even schools because of dramatic rate hikes. It would certainly be unfortunate to lose aluminum industry jobs and, barring the unprecedented circumstances our region faces, I would do whatever I could to protect these jobs, including maintaining my long-standing fight for fair trade. However, if a special deal is given to the DSIs, it means substantial job loss in other businesses and industries. This would be on top of the tens of thousands of jobs that will be lost just due to the BPA rate increase.

According to the Northwest Energy Coalition, even at current market prices, it takes about $2 to $5 worth of electricity to produce a pound of aluminum that sells for only 70 cents. The harsh reality is, if BPA merely passes through large rate increases to all customers, under take-or-pay contracts without remarketing rights, the DSIs would close and they would still have to pay for the power even though the power would revert back to BPA for sale to other customers. While that would benefit BPA, it would be a disaster for the DSI employees, who would get nothing.

Setting a bad precedent

Finally, as mentioned previously in this report, the Northeast-Midwest Caucus in Congress has long been agitating to force BPA and the other Power Marketing Administrations to sell their power at market rates. The DSIs propose to do the dirty work for those in Congress who would like to destroy BPA by beginning to push the market rate boulder down the incline. Once BPA began selling a portion of its power at market rates, it will be nearly impossible to hold back those who argue BPA should sell all of its power at market rates. If you think that's not a real threat, consider this: the Northwest (OR, WA, ID, MT) has 17 Representatives in Congress and 8 Senators, the Northeast Midwest Caucus has 114 Representatives and 36 Senators. That is not a balance of power that would be kind to the Northwest in a battle.

A better alternative

Fortunately, there is a proposal to reduce BPA's need to buy expensive wholesale power on the market while ensuring DSI employees remain whole. BPA and the DSIs should agree to modest payments to the DSIs in return for getting off the BPA grid. These payments should be made with the stipulation that the DSIs use the money to provide pay and benefits to workers, including retraining if the DSI does not intend to remain operational or reopen in the future, and to build their own generation.

Appendix A

DSI Remarketing in FY2001

Amounts in $ millions

	Remarketing Revenue	Money Still Owed to BPA under 1996 Contracts	Debt Forgiven by BPA from 1996 Contracts	Revenue Shared with BPA	Net Financia Gain	Possible Additional Net Revenue Remarketing at $350/MWhr	Possible Additional Net Revenue from Load Curtailment at $95/MWhr
Remarketing							
Columbia Falls	$115	$7			$108	$92	
Columbia Falls Addendum	$269	$25		$60	$184		
Kaiser	$485	$59			$426	$45	
Oremet	$2.7	$0.2			$2.5	$17	
Goldendale/Northwest	$64	$13			$51		
Goldendale/Northwest Addendum	$416	$38		$85	$293		
Load Curtailment							
Atofina	$5.0	$1.0			$4.0		$23
Vanalco	$1.2	$0.3			$0.9		
Alcoa *	$44		$11		$55		$36
Alcoa Addendum *	$135		$20		$155		
Longview *	$130		$43		$173		
TOTAL	$1,667	$144	$74	$145	$1,452	$153	$59

*DSI sold to Bonneville at below-market rate

Source: Bonneville Power Administration (data as of March 31, 2001)